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Protecting Prosperity From Protectionism



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Following is an address by Allen Wallis, Under Secretary for Economic Affairs, before the Economic Policy Council of the United Nations Association, Washington, D.C., January 17, 1986.

Two months ago marked the 100th anniversary of one of the greatest economists, Frank Knight, who for more than 40 years was a professor of economics at the University of Chicago. He was, in fact, "the fountainhead of the 'Chicago school' of economics." To mark that centenary, Herbert Stein published in *The AEI Economist* a selection of Knight's writings.

Although Stein described these quotations as "outside the field of economic theory," two of them make an appropriate introduction to my remarks on international economics.

The first is "Frank Knight's first law of talk." It is patterned after Gresham's law of currencies, propounded in the 16th century, and says that "cheaper talk drives out of circulation that which is less cheap."

The second quotation from Frank Knight is something he said in questioning whether it is worthwhile to try to teach economics—which is what he did throughout his long life. "What point is there in propagating sound economic principles," he asked, "if the electorate is set to have the country run on the principle that the objective in trade is to get rid of as much as possible and get as little as possible in return?"

About the time that Frank Knight was born, a century ago, Henry George, a San Francisco economist, pointed out that a protective tariff and a naval blockade are alike, in that both seek to prevent trade. The difference is that a blockade harms our enemies by obstructing their trade, while a protective tariff harms our own people by obstructing their trade. Eighty years ago, Ambrose Bierce, another San Franciscan, threw a different light on protective tariffs when he said that they protect businessmen against the greed of consumers.

Today's proponents of protection make different claims. They say, first and foremost, that protection can save jobs for American workers. They assert that protection is necessary to maintain the American standard of living—to stave off the low wages that they say would be necessary for our industries to compete.

They see protection as the key to preventing the "deindustrialization" of America. Protection, according to its supporters, could bring an end to our trade deficit and raise the revenue necessary to balance the Federal budget at the expense of foreigners who would pay the import duties. Some claim that we need protectionist legislation as a bargaining chip to obtain free access to foreign markets for our own exports.

Common Economic Fallacies

No matter how alluring these claims may be, they are fallacies—cheap talk which, too often, drives out sound ideas. I ask you to examine with me half-a-dozen of the fallacies.

Fallacy number 1 is that when we import, we export jobs; that we would have more jobs if we were to reduce our imports. During the past 3 years, we have experienced record trade deficits but we have added about 9 million jobs, and our unemployment rate has fallen by more than a third. Europe, on the other hand, is far more protectionist than we, but it has experienced economic stagnation for more than a decade. Total employment there is virtually the same now as it was 10 years ago; and since the labor force has grown, unemployment has grown. The combination of the protectionist common agricultural policy, various restrictive trading arrangements for industrial goods, and a wide variety of protections for special purposes—for geographic regions against plant closings or relocations, for employees against layoffs, for existing suppliers against innovations—all of these make Europe a less open market than America.

Has this protection helped Europe? No, of course not; just the opposite. Protection has contributed to economic rigidities in Europe which, in turn, are a major cause of its dismal economic performance.

Our imports are large because our economy is strong. Our trade deficit would be lower if our economy were not so strong and if it were not such an attractive place to invest, but we would be worse off.

Fallacy number 2 is that foreigners bear the cost of protection because it is their goods which are kept out of our market. Each job regarded as saved in a protected industry entails a high and continuing cost to the rest of us. For example, the Council of Economic Advisers estimated last summer that the protection proposed for the U.S. shoe industry, which the President rejected, would have saved some 30,000 jobs. But the average cost per job saved—a cost which American consumers would have paid in the form of higher prices for both domestic and imported shoes—would have been about \$50,000 per year. The average employee in our shoe industry, who earns about \$14,000 per year, would have seen little of this money. Some of the money would have appeared on the bottom line of protected firms' income statements, but much would have gone to foreign producers in the form of higher prices.

Another example: between 1981 and March 1985, Japanese automobile producers restricted their exports to this country. (They still do, but at a higher level.) The International Trade Commission has estimated that these restrictions saved 44,000 jobs in the domestic automobile industry, but they cost American consumers \$16 billion during the 4 years. In other words, each job saved in the U.S. industry cost Americans about \$90,000 per year. The Japanese automobile companies enjoyed record profits during that period, mostly from elevating their prices in America. If the companies had gotten together and agreed to gouge Americans that way, our antitrust division would have gone after them with a vengeance—as it should have.

Protection does not affect total employment. It simply shifts employment from more efficient industries to less efficient industries, thus reducing our national income.

Fallacy number 3 is that imports are causing the "deindustrialization" of America and creating a "hamburger economy." The fact is that there is no "deindustrialization" of America. Manufacturing contributes just about the same fraction of our total output now that it has for at least 30 years—just under one quarter. It is true that

the fraction of total employment accounted for by manufacturing has declined; it is only about half what it was a generation ago. The change in the relationship between employment and output reflects productivity gains, a major achievement of U.S. manufacturers. As for a "hamburger economy," service workers include doctors, nurses, lawyers, engineers, architects, teachers, programmers, journalists, lobbyists, and probably most of us in this room.

Some industries, to be sure, are declining. Steel is one. The decline of the steel industry is attributable, but only in part, to competition from abroad. However, the United States now consumes little more steel than it did 20 years ago, and our steel industry uses only half as many workers. A basic problem faced by our steel industry is that the resources used to produce a ton of steel can produce other products in our economy that are worth more than are the alternative products that can be produced in some other countries with the resources they use for a ton of steel.

It is comparative advantage, not absolute advantage, that influences international trade. If steel costs three times as much as another commodity in the United States, but only twice as much in another country, it will pay us to buy steel from the other country, and it will pay them to buy the other commodity from us. It is the fact that comparative costs differ from one country to another that makes international trade mutually beneficial, regardless of absolute costs.

Comparative costs change. Permitting changes in comparative costs to be reflected, through market forces, in changes in our imports and exports has kept the U.S. economy internationally competitive and permitted us to grow more rapidly than those nations which have attempted to frustrate the workings of the market.

Fallacy number 4 is that high wages make us noncompetitive internationally. The usual argument linking wages to noncompetitiveness compares our hourly wage rates to those abroad. Such a comparison ignores the productivity of American workers, which, overall, is among the highest in the world. We cannot have a comparative advantage in the production of all goods, so we cannot be competitive internationally in everything. For several decades, how-

ever, the United States has been the world's largest exporter, and our exports have been trending upward at a faster rate than the rest of our GNP [gross national product]. The fact that we are competitive internationally in many sectors is one of the reasons our wages are as high as they are.

Fallacy number 5 is that protection can eliminate the deficits in our trade and current accounts. In recent years, the U.S. economy has abounded in investment opportunities, but investment opportunities in most other countries have been less than here. As a result, there is a substantial flow of foreign capital into the United States, and there has been a great reduction in the outflow, resulting in a large increase in net inflow.

Since accounts must balance, the surplus in our flow of capital necessarily is accompanied by a deficit in our flow of goods and services. This deficit will diminish if, and only if, the net inflow of capital diminishes. That could come about through better economic policies abroad that improve the relative attractiveness of investment opportunities abroad. It could come about through deterioration of investment opportunities here. It could come about also by increased saving here or decreased saving abroad. But the deficit will not be affected by trade policies, except indirectly if they alter the relation between total investment—foreign and domestic—and domestic saving.

Government spending absorbs a substantial portion of our income that could be saved and made available for investment. As you know, the Administration is working with the Congress to reduce government spending and, thereby, reduce the government's absorption of our national income. Getting our fiscal house in order would be a useful step toward reducing our trade and current-account deficits, just as establishing a better climate for growth and investment abroad would be a useful step by our major trading partners. (I commend to your attention the editorial in today's *Wall Street Journal*, entitled "Lecture to the Europeans"—which is, in fact, a lecture to the Japanese, too.)

The deficits in current accounts are rooted in U.S. and foreign economic conditions, and they will change only as those conditions change, not as trade policy changes.

Fallacy number 6 is that by imposing new tariffs, we can generate revenues which will make a substantial contribution to balancing our Federal budget. Earlier this year, the press

reported the results of a study of this question by a leading economic forecasting firm. (The study itself was not made public.) That firm ran a simulation of its model of the U.S. economy assuming a temporary 20-percentage-point tariff surcharge applied to all U.S. imports in 1986, to be phased out by the end of 1988. The press reported that the duty would raise \$80 billion in new revenue during 1986—and that foreigners would pay half of it.

We were interested in these results and asked our economists to examine the analysis. We discovered that the study assumed that purchasers of imports will not reduce their purchases when prices rise substantially and that, despite the publicity that would precede the passage of such legislation, buyers of foreign goods would neither stock up before the temporary duty took effect nor draw down their inventories before it ended. Finally, the analysis assumed that our trading partners would not retaliate.

The State Department is a client of the same forecasting firm; so we asked for a set of simulations of the effect of a 20-percentage-point import surcharge on the same model of the U.S. economy, but using more plausible assumptions. The new results show that the tariff surcharge would raise much less revenue; that our exports would fall; that GNP growth would be reduced; and that U.S. inflation, unemployment, and interest rates would rise. In time, weakness in the U.S. economy would cause the budget deficit to widen further. With this kind of economic modelling, "you pays your money and you takes your choice"—of assumptions, hence, of conclusions.

National Security Concerns

Protection is occasionally justified on national security grounds. (In fact, those who cannot make a case on other grounds often try national security, but a few of those cases remind me of Samuel Johnson's 18th-century definition of patriotism as "the last refuge of scoundrels.") Today, our national security depends on maintaining a technological edge over potential adversaries. We need to foster a climate conducive to innovation at home and to maintain access to the technological innovations of others. Protectionism breeds stagnation and, even in such critical industries as semiconductors, it is likely to be inimical to national security. Our defense equipment must be the best that can be made, not just the best that can be 100% American.

The President's Trade Program

Enough on the negatives, even though the list of fallacies is anything but complete. Let me turn to President Reagan's trade program, which deals with the same issues in a positive and constructive manner.

The President has pursued and, recently, has reaffirmed vigorously, a program that will keep our country strong and competitive while, at the same time, addressing the trade problems caused by rapid change and the strong dollar.

First, and most important, the President has directed the Special Trade Representative to negotiate with our trading partners to strengthen the rules of the General Agreement on Tariffs and Trade (GATT), under which international trade is conducted. Recently, at a meeting of the GATT in Geneva, the United States gained the agreement of other countries to accelerate preparations for what is known as a new round of multilateral trade negotiations. Our five most important objectives in this new round are:

- Improved access to other countries' markets for services;
- Better protection of our rights in intellectual property—patents, copyrights, trademarks, designs, programs, music, movies, and so forth;
- Increased discipline over the use of subsidies, particularly in agriculture;
- Tighter rules governing actions to safeguard troubled industries; and
- A more effective procedure for settling disputes.

Second, the President has notified Congress that we will explore the advantages that might be gained from a free trade area with Canada, which is our largest trading partner.

Third, the Secretary of State is accelerating negotiations to open markets in Japan, which is our largest overseas customer. Last January, in a meeting with President Reagan, Prime Minister Nakasone took the initiative in suggesting these negotiations. They are unique, in that both sides have the same set of instructions: to identify and remove impediments to access to Japan's market. Despite widespread skepticism at the start, these negotiations have already yielded important changes in Japanese practices, regulations, and laws and have resulted in large sales that, a year ago, would have been impossible. We

have made major progress in opening Japan's markets to imports of telecommunications equipment, forest products, medical equipment, pharmaceuticals, and electronics and in liberalizing its financial markets.

We have made significant progress also in opening up Japanese markets for transportation services. Three new U.S. air carriers will be authorized between the United States and Japan. On the maritime side, we have managed to open a significant crack in the market for carriage of tobacco. Formerly, all shipments of U.S. tobacco to Japan were carried on Japanese ships. Just last Friday, one of the largest Japanese automobile companies announced that some of its cars for the United States will be shipped in a U.S. flag vessel.

Much of the Japanese economy, notwithstanding its popular image, is inefficient. There are numerous depressed industries, the financial system does not channel savings effectively into productive domestic uses, and much of the distribution system is primitive. The government there is actively considering measures that would reduce Japan's trade surplus by providing incentives to invest more of its savings at home.

Fourth, the Administration is combating restrictive practices in both aviation and ocean shipping. During the last 5 years, many problems relating to conduct of business have been eliminated or minimized for air carriers, and restrictive cargo allocation schemes that some countries have sought to impose on their maritime trade with the United States have been thwarted.

Fifth, the President has begun, for the first time, to use his authority to initiate investigations of trade-distorting practices of foreign countries, instead of waiting for American businesses to initiate them. Investigations underway concern Korean barriers to foreign insurance companies, Brazilian restrictions on computer imports, Korean violations of intellectual property rights, and Japanese restrictions on imported tobacco. Trade actions, by themselves, as I said earlier, cannot correct our trade deficit—that requires fundamental changes in our economy and in the economies of our main trading partners—but trade actions can increase efficiency and raise the national incomes of ourselves and our trading partners.

Sixth, the President authorized the Secretary of the Treasury to meet with key finance ministers in September in New York to seek agreement on ways other countries could improve their economic performance and strengthen their currencies. These nations are

beginning to remove regulations, rigidities, and tax disincentives that hinder growth in their economies. Many European leaders have told the President that they want to learn from our experience.

Seventh, the United States must do its share to restore better balance in the world economy, and the President is committed to reducing excessive government spending. Congress has enacted legislation that improves the prospects for achieving a balanced budget by 1990. This will enhance our competitive position by releasing resources that can be used more productively in the private sector.

The President and the Administration have, in fact, been emphasizing these points ever since they took office 5 years ago. The President has expounded them during each of the four economic summits of industrialized countries that he has attended. At last May's summit in Bonn, there was broad agreement on strategies to achieve these objectives. The pace of change, however, has been slow, and the pressure to take counterproductive protectionist action has intensified.

Taken as a whole, the President's program will help to keep our economy tough, resilient, and growing. This will assure that the economy will be able to support the defense effort needed to protect ourselves and our friends and allies. It will provide the stimulus to innovation needed to maintain a technological edge over our adversaries. Open markets and competition will help to keep us strong.

The President's program will open new opportunities for mutually beneficial trade. As we expand into new markets, we will exploit the gains to be had from an international division of labor based on comparative advantage. In this way, open markets and competition will make us richer.

Finally, the President's program will minimize the Federal Government's interference with commerce. The government does not need to tell producers what they can make or how to make it, and it does not need to tell consumers what they can buy and how to use it. (It does too much of that already.) By restraining the scope and the size of government, the program will allow our citizens to make their own decisions on economic issues. Open markets and competition will keep us free and prosperous.

Conclusion

To conclude: prosperity and protection are inconsistent; we will not let the fallacies of protectionism delude us. The American people have expressed their desire for less government in each of the last three presidential elections. On the domestic front, the President's tax program, the refreshing breezes of deregulation, and the determination to beat inflation have all contributed to a remarkably strong and balanced economy.

We are determined to do the same on the international front. We will not try to retreat into a "Fortress America." We are in an interdependent world, and government regulation of trade is no better internationally than it is domestically. Protection is government intervention in international markets. Prosperity is our goal; but, make no mistake about it, protection is its enemy. ■

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